DIRECT TESTIMONY OF
THOMAS R. OSBORNE
ON BEHALF OF
SOUTH CAROLINA ELECTRIC AND GAS COMPANY
DOCKET NO. 2004-178-E

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Thomas R. Osborne. I am a Managing Director in the Global Power Group within UBS Investment Bank ("UBS"). My business address is UBS Investment Bank LLC, 299 Park Avenue, New York, NY 10171.

Q. MR. OSBORNE PLEASE STATE YOUR EDUCATIONAL BACKGROUND.

A. I hold a Bachelor of Arts degree, with distinction, from the University of Virginia, where I was elected to Phi Beta Kappa.

Q. WHAT IS YOUR BUSINESS BACKGROUND?

A. As a Managing Director within the Global Power Group at UBS Investment Bank, I am primarily responsible for investment banking coverage of regulated electric, gas and water utility companies, independent power producers and related power industry participants. I joined UBS Investment Bank's predecessor firm in

May 2001 after spending five years as a Director in the Global Energy Group at Credit Suisse First Boston. Prior to joining Credit Suisse First Boston, I spent nine years (1987-1996) in the Utility Investment Banking Group at PaineWebber Incorporated, holding the titles of analyst, associate, vice president and first vice president. During my seventeen years of investment banking experience, I have worked on transactions with an aggregate value in excess of US$40 billion. I have extensive experience with corporate utility issuers in the equity and fixed income capital markets. Additionally, I have advised utilities on numerous mergers and acquisitions ("M&A") and generation asset divestitures, as well as restructurings. In recent years I led the financial advisory teams within UBS for numerous projects including a fairness opinion on behalf of TXU Corp in the divestiture of its Australian businesses, Sierra Pacific Resources' liability management and debt restructuring program, and numerous capital markets transactions, including recent issuances of bonds by Midwest Generation and Sempra Energy.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA?

A. Yes. In January 2002, in Docket No. 01-220-6, I provided testimony on behalf of South Carolina Pipeline Corporation with respect to identifying a group of publicly traded companies that faced similar business and financial risks to those of the applicant. That case was subsequently withdrawn.

In November 2002, in Docket No. 2002-223-E, I provided testimony on behalf of South Carolina Electric and Gas ("SCE&G" or the "Company") with respect to identifying publicly traded companies that face business and financial risks comparable to those of SCE&G.

Q. MR. OSBORNE, PLEASE DESCRIBE THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING.

A. South Carolina Electric and Gas ("SCE&G" or the "Company") has requested my expert opinion in identifying publicly traded companies (the "Peer Group") that face business and financial risks comparable to those of SCE&G. The Peer Group is included as Exhibit Nos. __ (TRO-1 and 2), which are attached to this testimony.

Q. PLEASE DISCUSS THE BUSINESS AND FINANCIAL RISKS FACED BY SCE&G AND THE COMPARABLE COMPANIES.

A. As part of my selection of companies for the Peer Group, I gave careful consideration to companies with business risks and financial risks similar to those of SCE&G.

As primarily regulated utilities, SCE&G and the Peer Group collectively are exposed to similar business risks which include, among other factors, regulatory and legislative actions including rate setting, deregulation or the threat of deregulation, and the imposition of environmental controls legislation; fluctuating power demand resulting from a variable macroeconomic environment and/or weather conditions; customer and/or asset concentration; commodity price volatility and fuel supply risk. These risk factors have the potential to materially affect a company's ability to effectively and profitably execute its business plan by causing, among other things, increased levels of counterparty risk; increased risk of default on debt obligations or on energy, fuel or transportation contracts and the resulting operating effects of the inability to execute such transactions; increased exposure to commodity price volatility and other macroeconomic risks; loss of competitive position within the respective service area; and/or higher levels of competition, which could lead to a lower market share and/or a higher risk customer mix. These business risks are reflected in metrics such as, among others, Standard and Poor's business profile scores, asset concentration, the percentage contribution of assets from unregulated businesses, fuel supply concentration, customer segmentation, and relative cost competitiveness.

In my analysis and selection of the Peer Group, I have also focused on financial metrics which provide information on SCE&G's risk-return profile. As with the business risks, SCE&G and the Peer Group collectively are exposed to similar financial risks which include, among other factors, rising operating costs and the negative effects that higher interest rates or restricted access to capital can have on capital-intensive businesses with relatively high levels of financial leverage, including reduced financial flexibility, as well as a deterioration in cash flows and the ability to service debt and pay dividends. These risk factors have the ability to adversely affect a company by increasing the cost of capital and/or restricting access to the capital markets, reducing financial flexibility thus increasing the cost of financial distress and/or likelihood of default, which could materially affect management's ability to effectively and profitably execute its business plan and which could thus negatively impact operating earnings. The financial metrics selected to assess these risks include market capitalization, financial leverage, interest coverage ratios, credit ratings, dividend yield and implied valuation multiples, among others. The rationale for the selection of these metrics was that they provide information and insight about a company's financial flexibility, quality of earnings and cash flows, sustainability of profit margins and ability to access the capital markets.

Q. PLEASE DISCUSS YOUR CONSIDERATIONS IN DETERMINING A PEER GROUP FOR SCE&G.

A. I have formulated my opinion based on seventeen years of financial industry experience within the utility sector. As you are aware, SCE&G's operations are primarily regulated electric and natural gas businesses. The Peer Group for SCE&G was selected based on a comparison of several key operational and financial metrics across a range of U.S. utility companies from various geographic regions. Among the key metrics I considered are: total market capitalization, capital structure, financial leverage, credit ratings, Standard and Poor's business profile score, the overall contribution of assets and operational flows from regulated electric and regulated gas operations, the extent of investment in unregulated businesses, and profitability.

The companies in the Peer Group were selected based upon their asset mix being comprised principally of utility operations. I also considered the fact that SCE&G serves approximately twice the number of electric customers as it does natural gas customers and as such employs fixed assets which are weighted towards the generation, transmission and distribution of electricity. Furthermore, SCE&G's financial leverage, credit ratings and profitability, among other factors, suggest that the company should be compared to a peer group with credit ratings reasonably proximate to those of SCE&G within the investment-grade spectrum.

These were my primary considerations when determining the appropriate subset of peers to select from the universe of regulated U.S. electric and gas utilities.

Q. COULD YOU PLEASE DESCRIBE THE FACTORS CURRENTLY INFLUENCING INVESTORS' VIEWS OF ELECTRIC AND GAS UTILITIES AS INVESTMENT VEHICLES?

A. In recent years, the risk of investing in the utility sector has increased significantly. Utilities currently face numerous uncertainties with regard to: (1) regulation; (2) the structure of the wholesale power markets; (3) interest rates; (4) fuel and other commodity prices; (5) environmental controls legislation; (6) rising pension, insurance and other costs; and, (7) macro-economic conditions, which impact customer growth and the growth in the demand for electricity. To continue to attract investor capital, the utility sector as a whole and each individual company must provide sufficiently high returns to compensate investors for their investment risks.

Over the last 24 months or so, many companies in the utilities sector have returned to a "back-to-basics" strategy that is focused on core regulated utility transmission, distribution and, in some cases, generation operations. This together with the desire to strengthen their credit position has pushed companies to shed non-core assets and reduce leverage. However, in the context of a somewhat constrained economic recovery, the sector will be challenged to produce longer-term growth from its remaining operations. Regulated electric and gas utilities tend to be slow growth businesses, a fact further compounded by margin pressures resulting from rising operating costs (including commodity supply costs, labor costs, pension and insurance expenses), and lingering oversupply and weak spark spreads in the wholesale markets which limit the profitability of off-system sales. The sector also continues to face environmental risks and the political uncertainties that often accompany such risk.

As a result of these pressures, many of the companies that have adopted the "back-to-basics" strategy have revised and lowered their long-term earnings growth guidance to the market. On August 1st, 2002, (the date of Exhibit No. ___ (TRO–2) in my testimony filed in Docket No. 2002-223-E) the average FirstCall long-term EPS growth rate for the power sector was approximately 7.2%, compared to approximately 5.1% as of July 1, 2004, the date of Exhibit No. ___ (TRO–1) as filed with this testimony.

Credit quality continues to be an important issue for electric utilities, and the rating agencies have made clear that they will closely scrutinize the regulatory decisions expected in the current industry "cycle" of rate case proceedings. Negative regulatory outcomes often result in lowered credit ratings and increased cost of capital. Equity financings have provided an opportunity for companies to repair balance sheets, but have led to share dilution resulting in lower EPS. This has placed pressure on utility share valuations. Utility share valuations are also likely to come under pressure in the face of rising interest rates, as historically utility share prices have tended to move inversely with long-term U.S. Treasury bond yields.

Q. WHAT IMPACT DOES THE REGULATOR HAVE ON THE PERCEIVED RISK OF UTILITY SECURITIES?

A. Capital is a limited financial resource that is allocated only to those entities that meet the risk-return requirements of investors. This allocation of financial resources occurs in the capital markets and as such, the actions of the state regulatory commission are not only a matter of public policy, but also a matter of financial policy as the attention of the financial markets is closely focused on how policies, actions, and decisions of state regulators affect investors' expected returns. The Commission and the Company have reason to give careful and thoughtful consideration to the requirements of the capital markets, because they are the mechanisms that price risk and allocate available capital to the users of capital – corporations, individuals and governments. The Commission's actions on matters such as cost recovery, balancing of customers' and shareholders' interests, quality of service, deregulation, and authorized rates of return materially impact valuation as a result of how adequately the company's expected return compensates investors for their assumption of risk.

Much to the credit of the Commission and SCE&G, the Company has been a financially sound utility. The Commission's continued support of SCE&G through its thoughtful and equitable actions is imperative to engendering investor confidence and maintaining a stable operating environment which, in turn, will allow SCE&G to more effectively compete for the capital resources that it requires to provide reliable service at a reasonable cost to its customers. Moreover, the Company's ability to earn reasonable rates of return on its equity is the product of both fair and timely regulatory treatment and positive financial and operating policies instituted by management. Continuation of these policies over the coming years will be critically important to investors in light of the lingering uncertainty around the evolving structure and regulation of the wholesale power markets, continuing competitive pressures and volatility of commodity prices.

Q. WHAT TYPE OF COMPANY WOULD YOU DEEM COMPARABLE FOR PURPOSES OF CALCULATING SCE&G'S COST OF CAPITAL?

A. I would consider an ideal comparable company to be a regulated generator, transmitter and distributor of electricity and natural gas to a stable mix of residential, industrial, and commercial customers. The company would have little in the way of unregulated operations but would carry principally regulatory and operational risk. Lastly, the company would operate in a state(s) which remain primarily regulated at the generation, transmission and distribution levels. To this end, I believe the companies listed in Exhibit Nos. ___ (TRO-1 and 2) accurately reflect comparable companies for SCE&G.

Q. WHY DO YOU VIEW THE COMPARABLES YOU HAVE IDENTIFIED AS APPROPRIATE?

A. There are very few publicly traded companies that have the same business model and business risk profile as SCE&G. For this reason, I have assembled a group of comparables whose risks are, in the aggregate, reasonably comparable to those of SCE&G. I have included companies from two categories: Integrated Utilities with both regulated electric and regulated natural gas operations, as well as Electric Utilities, which based on SCE&G's status as primarily an electric service provider, also provide a fair proxy for the Company. Each of these companies was selected based on its overall comparability and its exposure to business and financial risks similar to those of SCE&G.

These companies are primarily regulated entities that have investment-grade credit ratings, have a relatively modest proportion of unregulated businesses, and have manageable exposure to commodity price volatility. These companies are comparable to SCE&G in that they are similar in size and face similar regulatory, operational, environmental, and general financial risk. I believe the Peer Group is thus an appropriate set of comparable companies for evaluating SCE&G's cost of equity capital.

Q. IN YOUR TESTIMONY IN SCE&G'S 2002 RATE CASE, YOU INCLUDED DPL INC., GREAT PLAINS ENERGY INC. AND IDACORP, INC. IN YOUR EXHIBIT NOS. ___ (TRO-1 AND 2) YOU HAVE EXCLUDED THESE THREE COMPANIES. WHY DO YOU NOW EXCLUDE THEM?

A. I now exclude these companies because they no longer meet the criteria for inclusion in the Peer Group. For various reasons, they no longer have financial and business characteristics suggesting that it would be appropriate to include them in an analysis designed to determine the cost of capital for SCE&G. I address my specific reasons for excluding each of these three companies in the following responses.

Q. WHY HAVE YOU EXCLUDED DPL INC. ("DPL")?

A. On July 30, 2003, Moody's downgraded DPL's senior unsecured credit rating to Ba1, which is below investment grade. Also, the company has not filed with the Securities and Exchange Commission its 2003 Form 10-K due to an internal accounting investigation and as a result, the company is currently unable to access the capital markets. For these reasons, the company is ineligible for inclusion in the Peer Group.

Q. WHY HAVE YOU EXCLUDED GREAT PLAINS ENERGY INC. ("GXP")?

A. On June 2, 2004, Standard & Poor's ("S&P") released new business profile scores for U.S. utility companies. GXP was assigned a business profile score of 7. According to credit research published by Standard & Poor's on June 25th, 2004: "The score reflects the primacy and average business profile of the company's integrated utility business, KCP&L… The score also reflects the above-average business risk and continued expansion of retail energy supplier affiliate Strategic Energy. The score assumes that Strategic Energy will continue to achieve high levels of sales and earnings growth through at least 2006, as projected by Great Plains."

While investment in unregulated businesses is not in my opinion cause for automatically excluding a company from the Peer Group, GXP's expansion of Strategic Energy when combined with GXP's S&P business profile score of 7 suggests that the company's business risks are materially different from those of SCE&G. For those reasons, I have excluded GXP from the Peer Group.

Q. WHY HAVE YOU EXCLUDED IDACORP, INC. ("IDA")?

A. I have excluded IDA because of the numerous recent changes to its operating profile. Since the end of 2002, IDA has undertaken a number of steps to address changes in the Western power markets and extreme drought affecting its hydro operations. In addition to shedding its non-core assets, the company cut its dividend by 35% on September 18, 2003. IDA has also experienced changing regulatory circumstances. The Idaho Public Utility Commission ("IPUC"), which historically has been viewed as relatively evenhanded in balancing the interests of shareholders and ratepayers, has recently issued a ruling, which is viewed by the market and me as punitive, granting IDA's utility subsidiary, Idaho Power, a general rate case increase of only $25.3 million, or 5.2%, versus a request of $85.6 million, or a 17% increase in rates. The IPUC's decision set IDA's allowed return on equity at only 10.25%, compared to 11.2% requested by the company. As a result of the negative regulatory outcome, both S&P and Moody's placed the company on creditwatch-negative with a review for possible downgrade. Furthermore, from the beginning of the year to the announcement of the rate decision, IDA's share price fell 9%, and declined an additional 5% upon release of the final order in this rate proceeding. Although I would not necessarily exclude a company based solely on its placement on creditwatch-negative, the combination of the increasingly adverse regulatory environment exhibited by this recent rate decision, along with the other challenges faced by the company at this time leads me to conclude that IDA is ineligible for inclusion in the Peer Group.

Q. WHY HAVE YOU INCLUDED WISCONSIN ENERGY CORPORATION ("WEC") AND WPS RESOURCES CORPORATION ("WPS") IN YOUR COMPARABLE PEER GROUP?

A. WEC has been included as it fulfills many of the criteria for inclusion in the Peer Group. The company's total market capitalization is within the range of mid-cap companies as set by Ibbotson, the company has investment grade credit ratings and a Standard and Poor's business profile score of 5. The company is active in the generation, transmission and distribution of electricity. It also has a high proportion of regulated assets, with only 17% of its capital invested in non-regulated assets.

I have included WPS because it also fulfills many of the criteria for inclusion in the Peer Group. The company's total market capitalization is within the range of mid-cap companies as set by Ibbotson, the company has investment grade credit ratings and a Standard and Poor's business profile score of 5. The company is active in the generation, transmission and distribution of electricity and has manageable exposure to non-regulated business.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.